The Outlook: Jan. 18, 2019

Silliness and solvency: two fun stories, today.

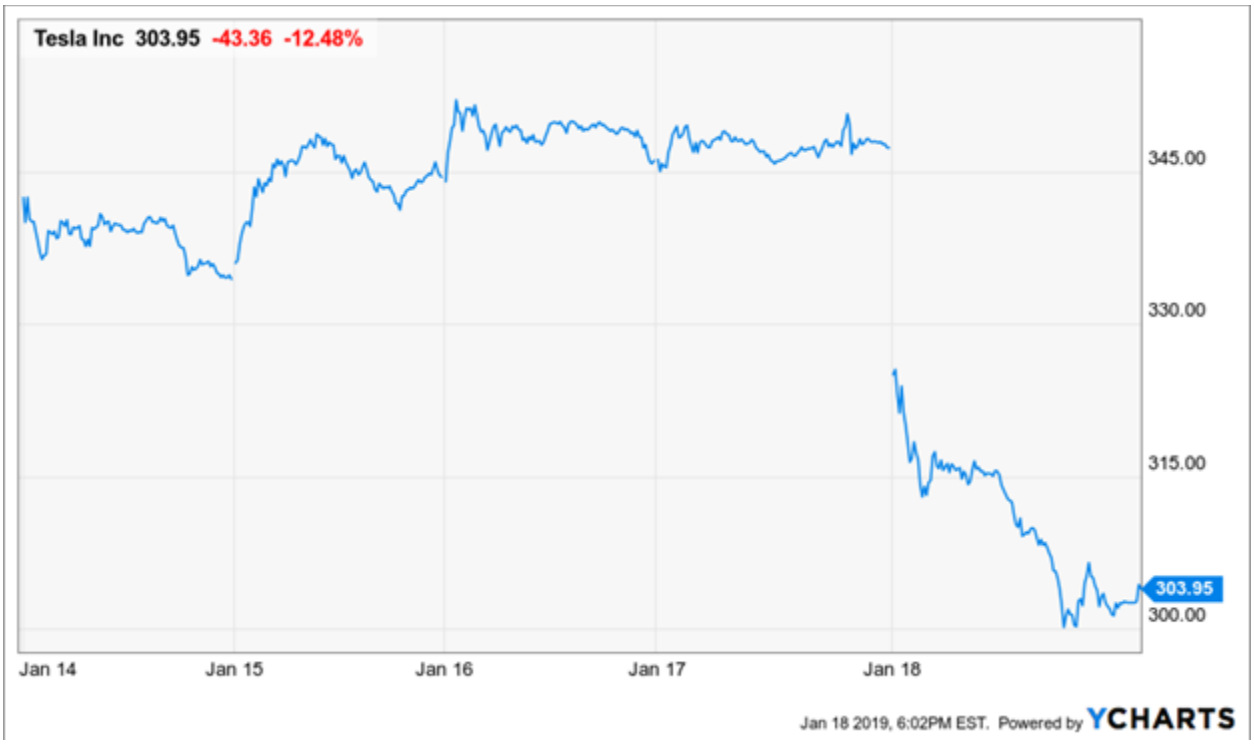
It's an old saying, but it's still as helpful as words can be for both kinds of people who inhabit the investment world: speculators and investors.

"The market can stay irrational longer than you can stay solvent."

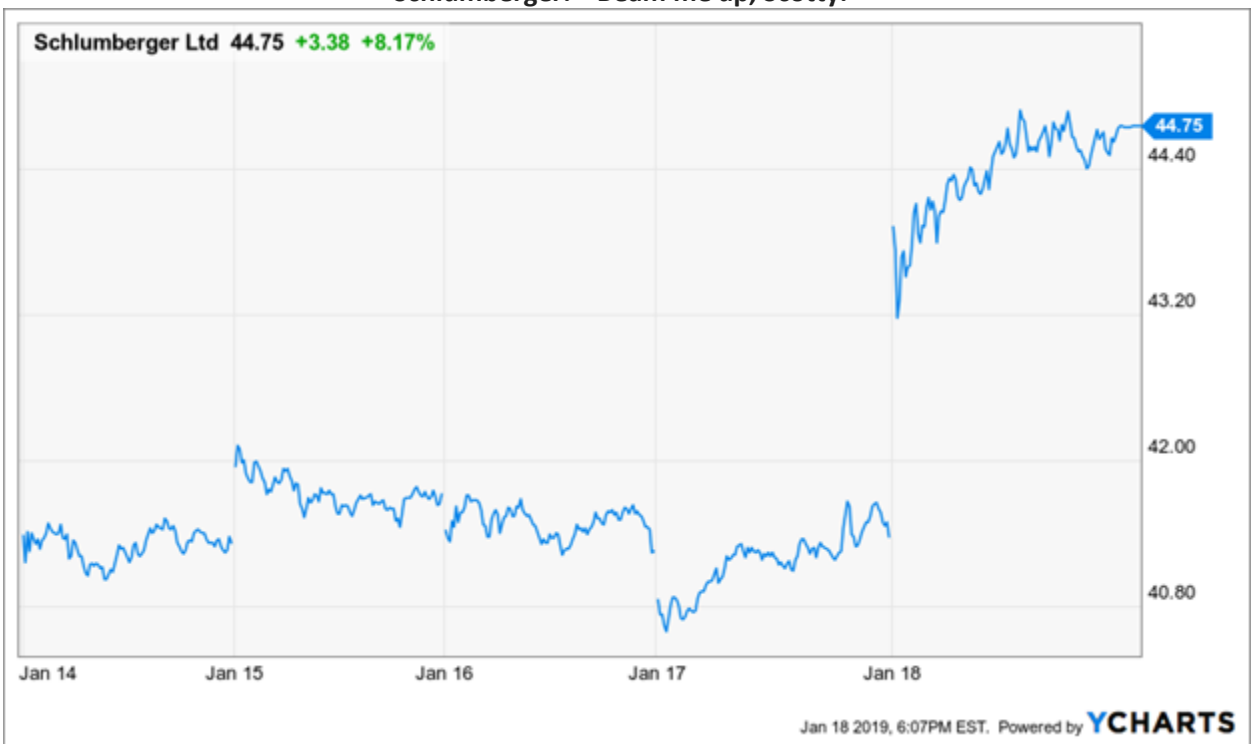
It has one profound meaning for speculators; and a very different profound meaning for investors. For speculators, it's a simple statement of fact about two things: the market's recurring behavior in valuing stocks—from one stock to all stocks—at levels which make no sense relative to real-world facts; and the certain eventual destruction of speculators who bet the market can't keep up the silliness longer than their lenders are willing to wait. For investors, though, who by definition have no lenders waiting to shut down their margin accounts, the meaning is different. It's a simple reminder that seeing the real world clearly, and investing accordingly, is half of how to succeed. The other half is nerve and patience, because though real-world facts always rule in the end, the market regularly pretends they never will, and keeps it up for a shocking long time.

Today gave us two wonderful examples of this part of the market's nature.

Tesla: Free Fall

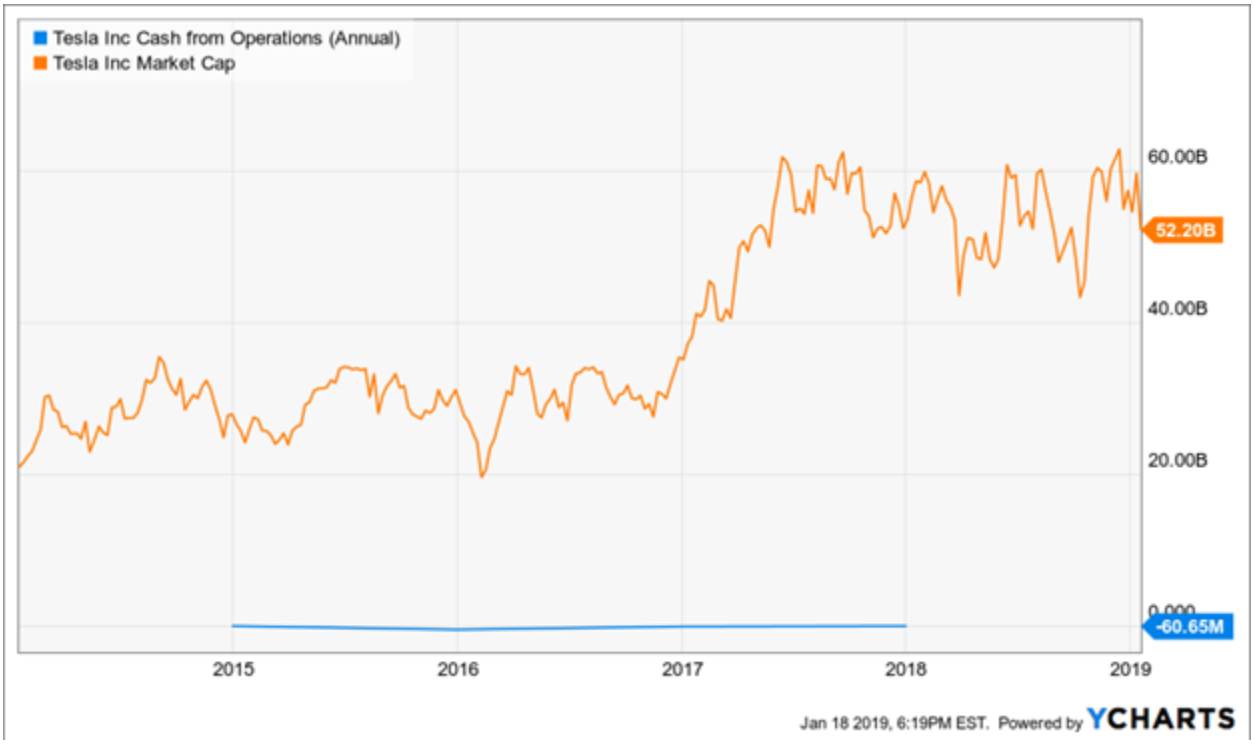


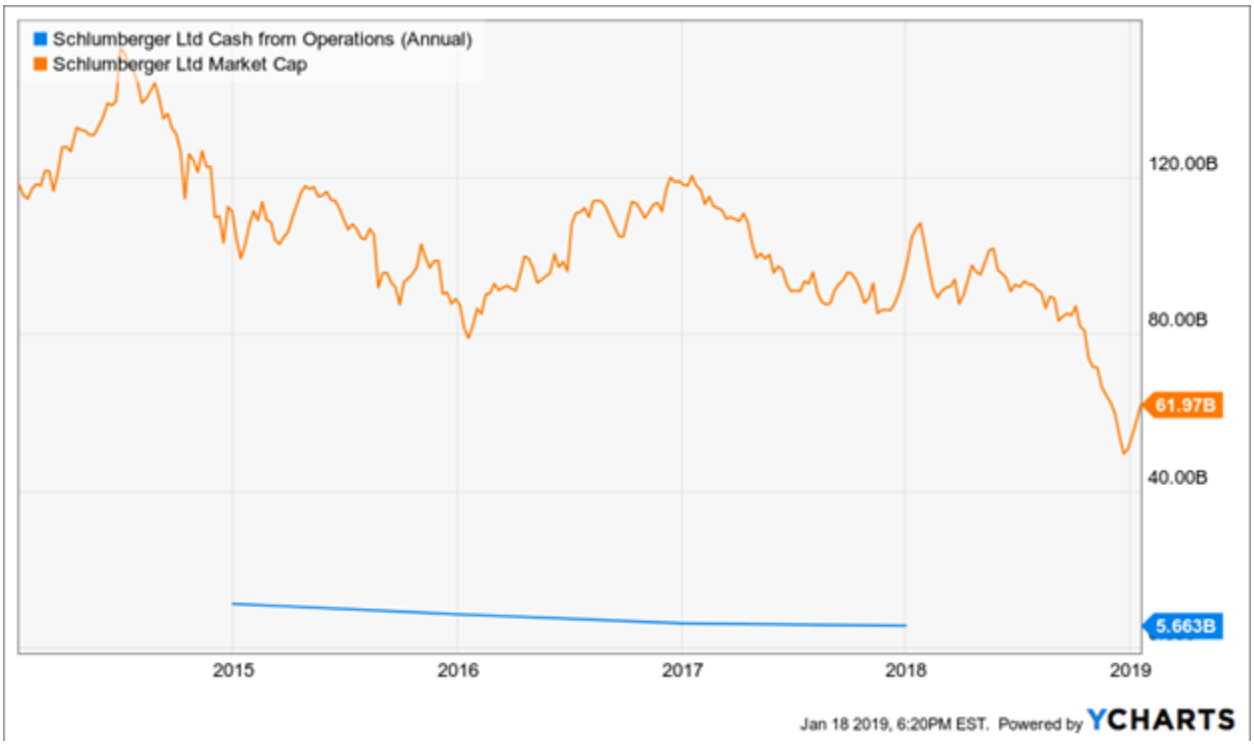
Schlumberger: "Beam me up, Scotty."



The empty space in Tesla's chart, when the bell rang this morning, was the first half of a 43-point, 12% drop. The market's speculating crowd is incomprehensibly big . . . so we might wonder if a few dozen of its members met their doom during that free-fall nanosecond. The empty space in Schlumberger's chart, on the other hand, went the other direction, being the first half of an 8% jump. "Rocket ride" doesn't do it justice; it was more like "Beam me up, Scotty." It was Schlumberger's biggest one-day jump since 2011.

"The market can stay irrational longer than you can stay solvent." Staying irrational—assigning absurd valuations—is exactly what it's been doing to both companies: Tesla, absurdly high; Schlumberger, absurdly low. Its Tesla silliness, though, has been going on for a length of time which qualified for "unbelievable" years ago. Its Schlumberger silliness has only lasted a few months. Let's look a little closer.





They aren't the clearest charts, so let's explain.

Until today, the market valued Tesla at 60 billion dollars—that is, for the whole company (the orange line.) Now the blue line: cash from operations. For the last 4 years, Tesla has burned (lost) cash at $60

million to $200 million each year. Yes . . . a company losing $100 million in average annual operating cash flow has been worth $60 billion, according to the stock market. Now Schlumberger. Until today, the market valued Schlumberger (the oil-equipment king of the world, with second place too far back to see) at 50 billion dollars. Over the last 4 years, Schlumberger has created from $6 billion to $11 billion of positive cash from operations.

Another way to put it: Tesla has been valued at infinity, meaning $60 billion divided by a negative number. Schlumberger has been valued at 10 times operating cash flow . . . quite a lot less than infinity. Getting poetic, the market has judged that Tesla is the sun, the moon and the stars; and Schlumberger is the mud under our feet.

What triggered those amazing "white spaces" in the two companies' charts, today?

Well, both companies made announcements. Tesla merely offered "guidance" about its next quarterly result, while also announcing 7,000 job cuts to "reduce the cost" of one of its star vehicles. Schlumberger announced its quarterly earnings. While the market acted as if both companies had dropped bombshell news (Tesla bad, Schumberger good) in fact, they did nothing of the kind. Tesla's remarks amounted to one more in its endless string of vague, hopeful and sometimes stridently optimistic predictions about the future—90% of which have been wrong. Schlumberger's earnings were about as expected, with cash production quite strong—exactly what its management had predicted 3 months ago, but the market ignored. On the future, Schlumberger's Paal Kibsgaard said essentially the same thing he's been saying all year:

> ***". . . we are seeing clear signs that (oil exploration) investments are starting to normalize and reflect a more sustainable financial stewardship of the global resource base. For the North America (shale) operators, this means that future investments will likely be much closer to the level that can be covered by free cash flow. Conversely, in the international markets apart from the Middle East and Russia, after four years of underinvestment and a focus on maximizing cash flow, the (oil exploration companies) are starting to see the need to invest in their resource base simply to maintain production at current levels.***
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> ***"For Schlumberger, this means that even with the current oil prices, we expect solid, single-digit growth in the international markets while in North Americaland, the increased cost of capital and focus on aligning investments closer to free cash flow has introduced more uncertainty to the outlook for both drilling and production activity."***

A bit of translation's needed for some of Mr. Kibsgaard's polite lingo—which is polite because he's talking about his customers. The underlined passage, up there, means: "The world's biggest oil companies slammed the spending brakes on finding new oil and/or coaxing more oil from their existing properties, 4 years ago when oil crashed. If they don't switch from the brakes to the gas pedal soon, they will be signing their own death warrants, dated 10 or 20 years from now." As Outlook has noted a few times when discussing the future squeeze on global oil supply, it takes a lot of money to make existing fields keep gushing their oil, and to find new fields. Less spending = less oil, eventually . . . and there has been a great deal less spending since 2014.

One of the mysteries of the investment world is the market's capacity for staying silly longer than we might dream possible. It works in both directions. The Tesla valuation silliness is truly astonishing, even when compared to some of the market's famous "bubbles." Next to Tesla, the market's "mud under our feet" valuation of Schlumberger has been merely a passing fit of silliness. But the same profound truth about the market—and about investing—applies to both of them: the facts matter, in the end. In fact, in the end the only things that matter are the facts about a company's real achievements, especially in the creation and growth of cash to reward its owners. The market's moods and departures from reality cannot stand up to the continuous onslaught of facts over time: good or bad. Both Tesla's free fall and Schlumberger's rocket ride, today, happened because as silly as it's been, the market has been aware of the two streams of facts—bad and good, respectively—and has been ready to dial back the silliness whenever some particular news item tips it over the edge, back to reality.

That's the nature of the market at its worst and its best. We own 10 companies very much like Schlumberger in their remarkably solid operating facts and their remarkably and temporarily cheap valuations. We own nothing in the same galaxy as Tesla—though it's certainly fun to watch. We strongly suspect we'll have a great deal more fun with our 10 stocks, in 2019, than we did in the last 3 months of 2018.

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